

City of Detroit

CITY COUNCIL

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TO: COUNCILMEMBERS

FROM: Irvin Corley, Jr., Director *ICJ*.

DATE: June 22, 2009

RE: Resolution to Implement Ordinance No. 05-09 by Authorizing the City of Detroit to Enter into the Collateral Agreement; Approve Amendments to the Service Contracts; Approve Amendments to the Hedge Agreements referred to in said Ordinance; and to Authorize the City to Take Other Action in Connection with the Settlement Transaction referred to in said Ordinance **(Recommend Approval) Line item 4 on today's Budget, Finance, and Audit Standing Committee agenda**

Currently before your Honorable Body is the above referenced resolution for your consideration. By approving this resolution, Council would be authorizing the final documents associated with the interest rate swap settlement transaction.

Background

As you recall, in January 2009, the City was faced with a termination payment of \$300 to \$400 million to the Counterparties (UBS and SBS; SBS is supported by Merrill Lynch) of the interest rate swaps associated with the 2006 Pension Obligation Certificates (POC's) used to fund certain unfunded accrued actuarial liabilities (UAAL) of the General Retirement System (GRS) and Police and Fire Retirement System (PFRS) of the City of Detroit. The huge termination payment became imminent when both the interest rate swap insurer and the City of Detroit dropped below investment grade status.

Due to the magnitude of the required termination payment, the City and Counterparties agreed to negotiate a termination agreement. The agreement reached relieves the City of the potential \$300 to \$400 million one-time termination payment, and instead, is paying the Counterparties starting in 2010, \$800,000 per year over the remaining life of the POC's, or 20 years, amortizing to approximately \$16 million.

However, the City has agreed to pledge its wagering (casino) tax revenue as collateral to pay the POC debt payment as well as the termination payment. The City's agreement reached with the Counterparties was codified in a 25-page Term Sheet, which encompasses the interest rate swap termination transaction.

City Council's Action on Tuesday, May 26, 2009

On Tuesday, May 26, 2009, your Honorable Body passed an ordinance that added Article XVI (16) to Chapter 18 of the City Code. The ordinance outlined the POC and interest rate swap transactions and the events, which lead to the huge termination payment pending in January 2009. The ordinance also deems acceptable the terms reached between the City and the Counterparties as described in the Term Sheet as an alternative to a one-time payment of \$300 to \$400 million.

This ordinance also recognizes the pledge of wagering taxes and related casino payments made under the casino development agreements as collateral to secure the payments to the Counterparties under the interest rate swap agreements, including the settlement payment of \$800,000 over the remaining life of the swaps.

In addition, this ordinance defined the final documents, or "definitive agreements", that would need to be executed to complete the transaction as described in the Term Sheet. The ordinance defines the definitive agreements as the Collateral Agreement, the Amendments to the 2006 GRS and PFRS Service Contracts, the Amendments to the 2006 Hedges (or interest rate swaps), the Irrevocable Instructions (which is attached to the Collateral Agreement), and such amendments to any other document executed in connection with the 2006 POCs and swap transaction to give effect of the aforementioned documents and amendments.

The major "other amendment" is the amendment to the Confirmation Letter (a/k/a "Revised Confirmation") associated with the interest rate swaps. The Confirmation Letter describes the economic terms of the interest rate swaps, and the revised confirmation letters reflect the change in the economic terms by adding the 10 basis points to the fixed rate payable by the City under the swaps, which amounts to the additional \$800,000 the City will be paying annually over the remaining life of the POC's per the on settlement transaction. Attachment I describes in more detail the definitive agreements.

Documents Currently Before City Council

Currently before your Honorable Body for approval are the definitive agreements previously discussed and a resolution implementing Ordinance 05-09 described as the "Authorizing Ordinance" to enter into the definitive agreements. This past Friday, Council should have received two binders from the Finance Department that contain the ordinance and definitive agreements.

Upon your Honorable Body's approval of Ordinance 05-09 and the definitive agreements, this would be considered the entire and complete agreement with respect to the interest rate swap settlement transaction recently agreed upon between the City and the Counterparties in lieu of the one-time payment of \$300 to \$400 million that was imminent in January 2009.

The Fiscal Analysis Division's Review of the Documents

Fiscal used the Term Sheet and the ordinance your Honorable Body passed on May 26th as the basis for its review of the definitive agreements and Ordinance 05-09. After reviewing the documents in detail and obtaining responses, both verbally and in writing, to our many questions regarding the documents, Fiscal has determined the following:

1. That Section 18-16-18 through Section 18-16-24 of the Ordinance passed on May 26th describes the major components that shall be in the definitive documents. The definitive documents (Collateral Agreement, Service Contract Amendments, Hedge (Swap) Amendments, and Irrevocable Instructions) that are currently before the Council **do** contain these major components.
2. That the Collateral Agreement in principal comports to the settlement of outstanding transactions as described in the Term Sheet, which include:
 - A. Usage of wagering taxes and certain casino payments as the City Pledge.
 - B. Establishment of a custodian containing a "receipts account" and a "holdback account" for the purpose of setting aside the City's pledge to ensure the City's obligation to pay the interest rate swap and settlement payments.
 - C. Certain thresholds, coverage requirements and payment requirements the City must maintain to avoid events of default and additional termination events.
 - D. Certain remedies to benefit of the counterparties if the City were to suffer an event of default or additional termination event.
 - E. The ability for the City to terminate the swap without penalty.

Council should note that the Collateral Agreement includes two new provisions not identified in the Term Sheet. The first one is, to the extent permitted by law, an indemnification clause located in Article XI, Section 11.5 of the Collateral Agreement that indemnifies the Counterparties from paying any costs associated with a lawsuit or legislative action that limits or sets aside pledges associated with the swaps and Service Corporations that were set up to receive funds from the City to pay the POC obligations. The Finance Department and the lawyers working on the settlement felt this was something minor "to give up" with the agreement to not have to pay a one-time payment of \$300 to \$400 termination payment. Fiscal concurs.

The second new provision is Article XIII of the Collateral Agreement that limits the amount of any interest rate obligation the City would be responsible to pay under the terms of the agreement in accordance with State law. Fiscal understands the maximum amount of any interest rate requirement is 24 percent in the State of Michigan. Given the low interest rates in the current bond market, it seems very unlikely that any interest rate the City would have to pay would reach 24 percent.

3. That the amended Hedge (Swap) agreements contain in principal the additional termination events that was described in the Term Sheet. These additional termination events (ATE's) were agreed to in lieu of the one-time termination

payment of \$300 to \$400 million, and the language supporting the one-time termination event is deleted in the swap agreements per the amended Hedge Agreement and the Collateral Agreement. **Fiscal feels this finding is paramount to Council's consideration for approving the definitive agreements and Ordinance 05-09.**

Although the ATEs could be considered "downsides" to the City's position with respect to the settlement transaction, we in Fiscal feels the City has a better chance of avoiding the ATEs (such as including the POC obligations in the budget, receiving sufficient wagering taxes throughout the remaining term of the POCs to meet the coverage requirements, the City improving its financial position to point of not receiving any additional downgrades, the City meeting its overall debt service and lawsuit settlement obligations, etc.) than having to pay a one-time termination obligation of \$300 to \$400 million.

In fact, the worse case scenario financially Fiscal sees in this settlement is if an event happens outside the City's control, such as a downgrade, the inability to meet coverage or a lawsuit, the City having to pay possibly a large termination settlement to the Counterparties of possibly \$300 million, **but over a seven year period.** At any time the City could back away from this potential huge obligation, if the interest rate market move in a direction that favors the City.

4. That Ordinance 05-09 no longer contains language allowing the Finance Director and the Board of Directors of the Service Corporations to make additions, deletions or modifications to the definitive agreements after your Honorable Body approves them, if such approval occurs.

Recommendation

Based on the above analysis, Fiscal recommends approval of the resolution implementing Ordinance 05-09 and definitive agreements, with waiver of reconsideration. Council has until June 26, 2009 to consider authorizing these documents, so it would be great if the Budget, Finance and Audit committee could move to put these items on under New Business for your Honorable Body's Formal Session on Tuesday, June 23, 2009 for your consideration.

If Council passes Ordinance 05-09 and the definitive agreements, these documents, along with the ordinance your Honorable Body passed on May 26th, would be considered the entire agreement with respect to the interest rate swap settlement transaction recently agreed to between the City and the Counterparties, thereby avoiding a huge one-time termination payment that could cripple the City of Detroit financially.

Attachment

cc: Council Divisions
Norman White, Finance Director

Audrey Jackson, Deputy Finance Director
Donita Crumpler, Manager II-Debt Manager
Pamela Scales, Budget Director
Allen Bass, Lewis & Munday
Kamau Marable, Mayor's Office

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ICJ:\ICORLEY\Final Documents for Interest Rate Swap Agreement 6_22_2009.doc

Attachment I

Detroit Swap Restructuring – Definitive Documents

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 - Confirmation Letter
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